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Trends and Developments

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Covenants Not to Compete in North Carolina Employment Agreements: How Employers Can Make the Most of Them

Introduction

In the midst of the Great Resignation (or, as it has also been dubbed, the "Great Reshuffle") businesses everywhere are being forced to deal with the realities of covenants not to compete as workers come and workers go in record numbers. North Carolina employers are asking both themselves and their employment law practitioners: "Should I require new employees to sign covenants not to compete? Are they even enforceable? Are they worth the time, expense and uncertainty of drafting, negotiating, maintaining and enforcing them?"

The answer depends on a number of factors – among the most important of which being that covenants meet the minimum standards for enforceability under North Carolina law before employers are use them. Although nonsolicitation covenants are often considered in conjunction with or in lieu of noncompetes, and raise similar issues, nonsolicitation covenants are beyond the scope of this review.

Background

A covenant not to compete (commonly referred to as "noncompete agreements" or "noncompetes") is an agreement in an employment contract under which an employee agrees not to perform similar work or services for a competing employer for a specified time after their employment ends.

Noncompete agreements in North Carolina are generally not favored by the courts. Traditional thinking is that contracts that restrain free trade and competition should be illegal. However, this interest in encouraging free and fair competition is tempered by the desire for certainty of contracts. Although courts disfavor restraints on trade, companies should be encouraged to invest in their business, educate employees in their trade, and trust their employees with confidential information and trade secrets.

The balance struck in North Carolina is that covenants not to compete are enforceable, but only if they are reasonable and no broader than is necessary to protect the employer's legitimate business interests.

Anatomy of a noncompete

In general, an enforceable noncompete in North Carolina must be:

- signed and in writing;
- based on valuable consideration;
- ancillary to an actual employment relationship;
- reasonable as to time, territory and scope; and
- narrowly drafted to protect a legitimate business interest of the employer.

Each of these elements will be considered in this article before addressing whether and how employers might decide to invest in such covenants.

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Noncompetes must be in writing and signed by the employee

To be enforceable, a noncompete agreement in North Carolina must be associated with a contract of employment and must be in writing. The agreement must be signed by the party who will be bound by the noncompete (eg, the employee) and is potentially enforceable even if the employer never signs the agreement.

Noncompetes must be based on consideration

The agreement must be based on valuable consideration, meaning that an employee signing a noncompete must receive an actual benefit in return for giving up the right to compete. When money is the consideration, the courts in North Carolina do not generally scrutinize or question the amount paid to the employee. At least one court has determined that a $100 signing bonus was sufficient, although practitioners generally view these amounts as the minimum required. Typically, the most common consideration provided is an initial offer of employment. Other examples of valid consideration may include increases in salary, promotions and signing bonuses.

Consideration that is considered "illusory" will normally render the noncompete agreement unenforceable. Examples of illusory consideration include promises of continuing at-will employment and offers of eligibility for discretionary bonuses.

Noncompetes must be ancillary to an actual employment relationship

The noncompete agreement must be secondary or subordinate to a valid purpose, such as an employment relationship. This ancillary requirement ensures that venting competition is not the chief object of the overall transaction, since contracts in restraint of competition are against public policy under North Carolina law.

The ancillary requirement does not mean that the noncompete must be incorporated in or accompanied by a written employment agreement. However, it is firmly established under North Carolina law that a noncompete cannot be part of a solely oral agreement. The parties may orally agree to enter into a noncompete at the outset of employment, so long as there is an agreement and understanding that a written, enforceable noncompete will follow the offer and acceptance of employment.

Noncompetes must be reasonable

The reasonableness of a covenant's time, territory or scope depends upon fact-specific inquiries that include considerations such as the employee's position, the business of the employer and the territory in which the employee works. The less connected they are to the individual employee in question, the greater the risk is that one-size-fits-all covenants will be deemed unenforceable.

i) Reasonable as to time

In North Carolina, restrictive time periods of up to two years are not considered per se unreasonable. Courts have enforced covenants up to three years and have described noncompetes lasting for five or more years as presumptively unreasonable, unless they are related to the sale of a business. More often than not, courts will look at the time and territory restrictions in tandem to determine reasonableness, such that a smaller territory restriction might allow a longer time restriction (and vice versa).

Courts may also consider "look-back" periods in their analysis. A noncompete that prohibits

competition "during employment and for two years following termination of employment for any reason" may be deemed unenforceable, depending on how many years the employee has been employed. If, for example, the employee is employed for four years, courts may determine that the four years of employment (or the "look-back period") is addable to the to the two year noncompete and find that, given the covenant is effectively six years, it is therefore unreasonable and unenforceable.

Some courts have suggested that a look-back period will not apply where the scope of prohibited conduct is keyed, and pertains only to customers with whom the employee in question has materially dealt. Still, the surest way to avoid this result is to draft the noncompetes to remove the restriction "during employment", as there are other ways to take action against current employees who are engaged in such activities, including claims for breach of contract, breach of fiduciary duty, and unfair and deceptive trade practices.

Some noncompete agreements provide for an extension of the restrictive period for any time during which the employee violates the noncompete. This is commonly referred to as a "tolling" period. In most cases, North Carolina courts have agreed that time spent in violation of an otherwise enforceable compete is tolled against the restricted period. After all, the employee should not get credit for time spent actually violating the noncompete.

ii) Reasonable as to territory

The territorial reach of the noncompete agreement should be no greater than necessary to protect the employer's legitimate business interests. Courts look to the following factors to determine whether the territory is reasonable:

- the area or scope of the restrictions;
- the area assigned to the employee during the employment;
- the area where the employee actually worked during the employment;
- the territory in which the employer operated during the employment;
- the nature of the employer's business; and
- the nature of the employee's duties and access to the employer's confidential information and business relationships.

Although practitioners will often draft territorial restrictions that mirror a company's entire territorial reach, this is riskier from an enforcement standpoint. Better practice is to customize the noncompete to reflect the employee's specific territory – for example, a salesperson whose assigned territory is in western North Carolina might be limited to those counties in which she sells her wares. Similarly, a physician who practices at a single office, of which most patients are located within 25 miles, might be limited to practicing within "a 25-mile radius of the practice location" or perhaps even any other new practice location where the physician later performs services. Of course, a chief executive officer and other key employees may warrant a broader restriction.

Depending upon the nature of the employee and the scope of the employee's territorial impact, North Carolina courts have upheld nationwide or even worldwide territorial restrictions if an employer can demonstrate a legitimate need for such restriction.

Territorial restrictions may also be defined based on location of customers rather than geography.

A noncompete agreement might limit an employee from competing in any zip code where certain customers are located, for example. Courts sometimes prefer customer-based territories because they necessarily take into account both the territorial reach and the business necessity for the covenant. A customer-based territory is more likely to be reasonable if it clearly defines the persons or entities included and limits the customers to those with whom the employee actually had material involvement.

iii) Reasonable as to scope/protection of legitimate business interests

The scope of the restricted activities must be no broader than necessary to protect the employer's legitimate business interest. As suggested above, this is often easier said than done and so many employers default by establishing a one-size-fits-all time, territory and scope restriction for all employees.

However, it is better practice to draft a narrowly tailored noncompete agreement that focuses on each individual employee and how that employee could most significantly harm the employer if the employee were to leave and compete. With that as the focus, the covenant's scope is more likely to be considered reasonable.

A noncompete that prevents an employee from working for a competitor in any capacity is usually unenforceable. This is often referred to as the "janitor rule". By way of an example, if a salesperson were bound by a noncompete that prohibited him from employment with any entity that provided services similar to the employer, this restriction would necessarily be overbroad.

As one court aptly noted, a general prohibition of any employment with a competitor - that is, one that would in theory prevent the employee from working even as a "janitor" – is overly broad and unenforceable. Similarly, North Carolina courts have found that language prohibiting an employee from "directly or indirectly" working for a competitor may be overbroad.

In the context of noncompete agreements, North Carolina courts have generally found employers to have a legitimate business interest in:

- protecting their business, client, customer and patient relationships;
- preserving confidential information and trade secrets; and
- avoiding loss or diminution of goodwill.

A practitioner who drafts covenants not to compete with the client's legitimate business interests as the guiding star will more likely craft a covenant that is reasonable and enforceable, as well as one to which prospective employees will more likely agree.

North Carolina courts have sometimes found that employers have a legitimate business interest in preventing former employees from using special skills acquired from the employer to subsequently compete against the employer. It is noteworthy that, when special skills or training are involved, the employee has also usually acquired confidential or proprietary information that the employer has a legitimate business interest in protecting.

No violation of public policy

It is against public policy in North Carolina to enforce a noncompete agreement that stifles normal competition and promotes a monopoly. It has also long been the rule that it is against public policy for lawyers to enter into noncompete agreements. North Carolina courts have also

found that physician noncompetes, particularly when the physician's specialty is needed in the community, may violate public policy.

Other considerations for drafting or enforcing covenants not to compete

Blue penciling

Noncompetes that might otherwise be overly broad in time, territory or scope may – at the court's discretion – be rehabilitated by "blue penciling". In some states, blue penciling is not permitted and in others the courts are given free rein to rewrite covenants to render them enforceable.

North Carolina has a middle ground approach known as "strict" blue penciling, which prohibits the court from rewriting the agreement but permits it to strike separable, offensive portions of the restriction – provided that the remaining portion is complete, reasonable and is enforceable on its own. If the remaining language of the restriction is incomplete or unintelligible, the entire restriction will be deemed unenforceable.

For this reason, practitioners often go to great lengths to draft covenants that can survive strict blue penciling, with varying outcomes. This includes using progressively narrow (or "cascading") restrictions – for example, a territorial restriction may be drafted to prohibit the hypothetical salesperson whose primary territory is the Southeast from competing "1) in the USA; 2) in the states of North Carolina, South Carolina, Georgia, and Virginia; and 3) in the state of North Carolina". The practice of "cascading" restrictions, while understandable, is not without risk.

The application of strict blue penciling is wholly discretionary. Many judges refuse to exercise the right to apply the doctrine. Such judges may take offense at a covenant that attempts to limit the employee, even theoretically, from competing in a territory much broader than is necessary for the employer's legitimate business interest and may decline to enforce the covenant altogether as a result.

Other practitioners inadvertently render the restriction ambiguous and unenforceable by using "and/or" in the above example. The use of the "and/or" conjunction may preclude a court from striking items from a list, as this term is considered conjunctive and, therefore, not deemed to join separable phrases that are eligible for strict blue penciling. As previously suggested, the better practice is to draft covenants that are tethered to the legitimate business interests of the employer with respect to each specific employee.

Choice of law

Restrictive covenants are often included within employment contracts that contain choice-of-law provisions – for example, a Florida-based employer whose employee lives and works only in North Carolina may seek the contract to include a noncompete agreement subject to Florida law. Broadly speaking, choice-of-law provisions will not be enforced if:

- there is no relationship between the parties and the chosen state or no reasonable or rational basis for using the chosen state; or
- when the chosen state's law violates the underlying public policy of the forum state.

In the example above, if the Florida-based employer sought to apply Delaware law to its North Carolina employees (and neither the employee nor the employer has any business ties to Delaware), a court would be unlikely to apply Delaware law despite the choice of law provision. The better practice is to make the

choice-of-law clause consistent with the jurisdiction and venue in which the company works and resides. This is not only more reasonable to the employee, but provides a more predictable enforcement standard for the employer.

Enforcement and remedies

More often than not, employers pursue immediate injunctive relief to enforce noncompete agreements. The pursuit of injunctive relief can be stressful and expensive for an employer. However, an employer who prevails at the temporary restraining order and preliminary injunction phases has for all intents and purposes won the case after a few short weeks of intense litigation. The mere fact the employer is willing to make the investment in injunctive relief can often be enough to convince the employee – and even the new employer – to settle.

Even if the employer is unable to obtain injunctive relief, the employer may still seek recovery of monetary damages against the employee for breach of contract. As a practical matter, though, many employees do not have the ability to pay a meaningful settlement or judgment, which explains why injunctive relief is often so important to the employer. An additional reason is that the failure to pursue injunctive relief with regard to one employee may result in a finding that the employer has waived its right to enforce such agreements with others.

Are noncompetes worth the investment?

Despite the time and expense required to draft, negotiate and maintain covenants not to compete, as well as the inherent uncertainty associated with court enforcement, noncompete agreements are an important and useful tool for employers as a means to:

- retain good employees;
- discourage poaching; and
- protect confidential information, trade secrets and unfair competition.

Indeed, the failure to have such agreements (along with nonsolicitation and confidentiality covenants) might even be deemed negligent, at least for key employees.

However, the benefit of noncompete agreements may be diminished if the employer expects all employees to sign the same or similar noncompete agreements. The greater number of agreements alone makes it more likely that employers will have to pursue more enforcement actions, if only to avoid claims of waiver. Thus it makes little sense for an employer to invest in enforcement action, especially when the competing employees present minimal risk to the employer.

Attempting enforcement against these same insignificant former employees also increases the likelihood that the employer's enforcement action will fail, as a "one-size-fits-all" approach is arguably unreasonable per se to the extent it treats all employees exactly the same regardless of their position, skills, access to confidential information, etc.

The greater risk to employers is that if one such covenant is invalidated, it opens the door for all of the employer's covenants to be successfully challenged. Prudent employers will therefore invest up front to identify their key employee positions and focus their attention on requiring noncompetes for them only, with a policy of consistent enforcement.

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Conclusion

Employers and employment practitioners will be well served by:

- appreciating the complexities and nuances of North Carolina case law governing noncompete agreements; and
- drafting agreements that are reasonable and thus have the greatest likelihood of success if enforcement actions are necessary.

A focus on the front end to identify employees who need such agreements – ie, those who present the greatest potential threat – is critical. The employer's goal should be to develop a noncompete agreement that is designed not to eliminate every risk, but rather to minimize the most significant risks. This will provide the most optimal protection for the employer while also reflecting well on the reasonableness of the employer and the agreement itself.

No agreement, no matter how carefully or competently written, can ever be perfect; there is no such thing as a "bulletproof" noncompete. Employers must therefore also look to the use of additional tools to protect their risks – ranging from aggressive reliance on other contractual restrictions on the one hand to defensive measures to foster employee satisfaction and loyalty on the other.

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Johnston, Allison & Hord, P.A. is a midsized, multidisciplined law firm offering the capabilities, expertise and sophistication usually found only at the largest firms. With an office in Charlotte, North Carolina, the firm employs approximately 47 attorneys who specialize in a variety of business-focused practice areas, including corporate, trusts and estates, real estate, construction, employment law, and litigation. Established in 1912, Johnston, Allison & Hord, P.A. is one of Charlotte's oldest and most respected law firms, offering clients exceptional legal services with a uniquely personal touch. The firm provides counsel that assimilates quality legal counsel with pragmatic business advice and is fully equipped to handle almost any matter, regardless of the scope of the client's business or the complexity of the issues. The controlled size of the firm allows Johnston, Allison & Hord, P.A. to handle smaller but equally important matters, in addition to large and complex cases – all with the hallmark personal service clients expect and deserve.

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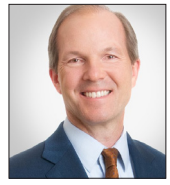

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